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QUESTION PRESENTED

Whether the taxable percentage deduction of North Carolina's former intangibles tax is consistent with the Commerce Clause of the United States Constitution.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

FULTON CORP., *Petitioner*

v.

JANICE H. FAULKNER, *Respondent*.

On Writ of Certiorari to the
Supreme Court of North Carolina

BRIEF OF RESPONDENT

STATEMENT

1. This case involves the interaction of two North Carolina taxes, one on corporate income and the other the State's since-repealed tax on intangible property, which includes corporate stock. Under the income tax, firms that conduct business entirely in North Carolina pay a tax on 100% of their income; firms that conduct only a portion of their business in North Carolina are taxed on the percentage of their income that is properly attributable to activities in the State. That percentage is determined by application of a conventional apportionment formula. First, the amounts of the firm's payroll, property and sales in North Carolina are

respectively divided by the firm's *total* payroll, property and sales. Those percentages, with the sales factor double-weighted, are themselves then averaged. The resulting figure is the percentage of the firm's total income that is taxable in North Carolina. N.C. Gen. Stat. § 105-130.4(i)-(l). See Pet. App. 3a-4a.¹ Once the tax base is determined, the income tax is applied at a rate of 7.75%. N.C. Gen. Stat. § 105-130.3.

During the period relevant here, the intangibles tax was imposed on the fair market value of specified intangibles, including shares of stock, that were owned by North Carolina residents. Under the so-called "taxable percentage deduction" provision of the tax statute, residents were permitted in calculating their intangibles tax liability to deduct a percentage of their shares' value equal to the percentage of the issuing corporation's income that was subject to tax in North Carolina, as determined through use of the corporate income tax apportionment formula. N.C. Gen. Stat. § 105-203.² Thus, for example, because 100% of the income of a corporation engaged in business exclusively in North Carolina

¹ In addition, certain nonbusiness investment income of corporations domiciled in North Carolina is allocated in its entirety to North Carolina for income tax purposes. N.C. Gen. Stat. § 105-130.4(c)-(g). See generally *Allied-Signal, Inc. v. Director*, 112 S. Ct. 2251, 2262 (1992).

² North Carolina uses the same taxable percentage system in determining the portion of stock dividends subject to tax. N.C. Gen. Stat. § 105-130.7. In fact, the taxable percentage deduction available under the intangibles tax actually incorporates by reference the percentage limitation on the dividends tax. See N.C. Gen. Stat. § 105-203(1), (2). Nonbusiness income of North Carolina domiciliaries that is allocated to the State for income tax purposes also is taken into account in determining the portion of share value subject to the intangibles tax. N.C. Gen. Stat. § 105-130.5.

would be subject to the State's income tax, a shareholder of that corporation could deduct 100% of the value of the shares (leaving no property tax liability). Conversely, shares of a corporation that did no business in North Carolina and consequently was not subject to the State's income tax would be taxed to the shareholder at 100% of their value. Shares of a corporation that did a portion of its business in North Carolina (say, 60%) would be deductible to that extent (meaning, in this example, that the shares would be taxable at 40% of their value). See Pet. App. 5a-6a. During the relevant period the tax was imposed at the rate of 25 cents per \$100 worth of stock.

As we explain in more detail below (at 21-23), the taxable percentage deduction was designed to avoid what was thought to be duplicative taxation of a single corporate value. In its initial form, the intangibles tax exempted all corporate shares, but was imposed on other intangibles at an unusually high rate. In 1928, the State Tax Commission accordingly proposed a revision of the tax. The Commission explained that

[s]hares of stock of domestic corporations are now exempt from taxation on the ground that the real and personal property of the corporation has paid its tax, presumably within the state, and that to tax the shares separately would be objectionable double taxation. Also on the ground that in so far as the corporation has high earning power with little or no tangible property, we are reaching it through our corporate excess tax.

State of North Carolina, Report of the Tax Commission to Gov. Angus Wilton McLean, at 356 (hereinafter cited as "1928 Report").³ The Commission therefore proposed extending the intangibles tax to corporate shares, while

³ For the Court's convenience, a copy of the relevant portion of the 1928 Report has been lodged with the Clerk of the Court.

avoiding duplicative taxation by exempting shares from the tax to the extent that the issuing corporation paid property or income tax to the State. *Id.* at 356-357. The Commission's recommendation was implemented in 1937, and the tax was put in something much like its current form in 1939. 1939 N.C. Sess. Laws c. 158 s. 705.

2. Petitioner is a North Carolina corporation that itself held stock in other corporations. In 1990, the tax year at issue here, petitioner owned shares of six corporations. Five of the six did no business or earned no income in North Carolina, and therefore were not subject to the State's income tax; petitioners' shares of those corporations were taxed at 100% of their market value. The sixth corporation, Food Lion, Inc., conducted 46% of its business in the State, meaning that 46% of its net income was subject to North Carolina's income tax and 54% of the value of its shares was subject to the intangibles tax. Pet. App. 21a.

In 1991, petitioner paid its intangibles tax for the 1990 tax year, which totaled some \$10,884, and then commenced this suit in state court for a refund, contending that the taxable percentage deduction discriminated against out-of-state firms and therefore was inconsistent with the Commerce Clause. The trial court ruled for the State. The North Carolina Court of Appeals reversed, holding the taxable percentage deduction unconstitutional. Pet. App. 18a-35a. That court nevertheless denied refund relief, however, holding as a matter of state law that the proper remedy for the constitutional violation was excision of the taxable percentage deduction from the tax statute, rather than invalidation of the intangibles tax as a whole. *Id.* at 32a-33a. The court added that retroactive application of the statute as revised would be inequitable. *Id.* at 33a.

A unanimous North Carolina Supreme Court then reversed in turn, holding the taxable percentage deduction constitutional. Pet. App. 1a-17a. The court began by

surveying decisions of this Court describing the compensatory tax doctrine (see *id.* at 7a), and then found this case controlled by *Darnell v. Indiana*, 226 U.S. 390 (1912). The state court explained that

[i]n *Darnell* the Supreme Court found substantial equality, sufficient to satisfy the Commerce Clause, in taxing the stock of foreign corporations not paying property taxes and taxing the property of domestic corporations. In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of "compensating" tax scheme the Supreme Court upheld in *Darnell*.

Pet. App. 10a-11a (footnote omitted).

The court rejected the argument that *Darnell* could be distinguished because that case had involved offsetting property taxes (one on tangible corporate property and one on shares) while the North Carolina system presented offsetting income and shares taxes. The court reasoned that it is "a sound generalization that corporate income, and income tax paid, are strongly related to the value of the corporation's stock." Pet. App. 12a. Indeed, the court found as a practical matter that, under the North Carolina regime, "most out-of-state corporations will in fact be paying less taxes to North Carolina, directly in the form of an income tax and indirectly in the form of an intangibles tax against shares, than a similar North Carolina corporation." *Id.* at 14a.

Finally, the court concluded that *Darnell* was consistent with more recent of this Court's decisions. *Id.* at 14a-17a.

3. Shortly after the decision below was issued, a bill to repeal the intangibles tax was introduced in the North Carolina Senate. N.C. Sen. Bill 8 (Jan. 26, 1995). The bill was reported favorably by committees of the North Carolina Senate and House on February 7, 1995, and March 8, 1995, respectively, and was approved by the respective Houses of the legislature on February 9, 1995, and April 17, 1995. The repeal became law on April 18, 1995. 1995 N.C. Sess. Laws ch. 41. The repeal does not have retroactive effect, however, and therefore does not affect the tax liability at issue in this case.

SUMMARY OF ARGUMENT

A. This case is controlled by *Darnell v. Indiana*, 226 U.S. 390 (1912). *Darnell* involved a Commerce Clause challenge to a tax that was in all essential respects identical to the one at issue in this case, and the Court in *Darnell* rejected arguments indistinguishable from those advanced here by petitioner. Indiana taxed the shares of foreign corporations, but exempted the shares issued by domestic corporations that themselves paid property tax to the State. The Court upheld this regime because it found that taxing "the property of domestic corporations and the stock of foreign corporations in similar cases" was "consistent with substantial equality notwithstanding the technical differences." *Id.* at 398. Petitioner's attempt to distinguish *Darnell* from this case on the theory that both of the taxes there fell on types of property (tangible property on the one hand and shares on the other) is unpersuasive; in fact, there can be no doubt that a tax on corporate income is a *better* proxy for one on corporate shares than is the tax on tangible corporate property upheld in *Darnell*.

B. This conclusion plainly comports with the compensatory tax doctrine as it has been articulated in the

Court's more recent decisions. *First*, North Carolina's corporate income tax qualifies as a levy on intrastate commerce for which the State properly may compensate. In arguing to the contrary, petitioner contends that the State lacks the power to impose a tax that compensates for the levy on corporate income because North Carolina could not directly tax the income of out-of-state firms that conduct no business in the State. But this contention rests on a fundamental misunderstanding of the compensatory tax doctrine: the very *point* of the doctrine is to permit States to tax values indirectly that they lack the power to reach directly. Here, firms that do business in North Carolina pay through the corporate income tax for that privilege, in the process supporting the functioning of the State's capital market; firms that are not subject to the income tax but that sell their shares to North Carolina residents pay their fair share of the costs of maintaining that capital market indirectly through the intangibles tax. This conclusion is confirmed by the history of the taxable percentage deduction, which establishes beyond peradventure that the income and intangibles taxes were regarded as duplicative of one another.

Second, the income and intangibles taxes are substantially equivalent. To comport with the requirements of the compensatory tax doctrine, the amount of the tax on interstate commerce "must be shown roughly to approximate" that on intrastate commerce. *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 114 S. Ct. 1345, 1352 (1994). Here, given the low rate of the intangibles tax, a firm would have to have an unusually high price-to-earnings ratio for the tax liability of its shareholders to exceed the income tax liability of a comparable corporation that confines its business to North Carolina. Indeed, there is little doubt — and petitioner does not deny — that the dollar burden imposed on interstate businesses through the shares tax will be considerably *lower*, in the vast run of cases, than that imposed on comparable intrastate firms by the income tax.

Third, the interstate and intrastate taxes fall on substantially equivalent events. While petitioner complains that the taxes are imposed on different activities and categories of taxpayers, that is the essential nature of a compensatory tax; compensating sales and use taxes, which fall on different events (sale rather than use of merchandise) and are paid by distinct classes of taxpayers (sellers rather than ultimate consumers of goods) are the paradigmatic example. Here, as a matter of economic reality there is a necessary, close, and manifest relationship between the value of corporate shares and the amount of corporate income. And in contrast to cases where the Court has found the compensatory tax doctrine inapplicable, the income and intangibles taxes in this case serve as mutually exclusive proxies for one another: firms that pay the state income tax do not pay the levy on intangibles, while firms whose shares are subject to the intangibles tax do not pay the income tax.

C. The taxable percentage deduction should not be invalidated under the "internal consistency test," which never has been applied to strike down a state tax like the one at issue here. While the test is used to determine whether a State is taxing more than its fair share of an interstate transaction, North Carolina here is trying to make out-of-state firms shoulder *their* fair share of the taxes used to support the capital market in which they participate. Moreover, even if the internal consistency principle would invalidate other sorts of complementary taxes, it should not be applied to invalidate a tax on intangible property, which historically has been thought unapportionable — and therefore subject to apparently duplicative taxation — because it has no identifiable location and draws distinct benefits from more than one State.

In nevertheless contending that the State must either forgo any tax on intangibles or apply the intangibles tax on precisely equivalent terms to the shares of in-state and out-of-state corporations, petitioner would place the State in an insurmountable bind. Petitioner's first approach would allow

out-of-state firms to escape making any contribution to the maintenance of the North Carolina capital market; the second would subject intrastate commerce to duplicative taxation. After all, we are here proceeding on the hypothesis that the income and intangibles taxes satisfy the requirements of the compensatory tax doctrine — which means that the taxable percentage deduction furthers a legitimate local purpose (that of avoiding duplicative taxation of in-state firms) that cannot be achieved by nondiscriminatory means. Requiring the State to disregard that purpose would contravene the basic understanding that the Commerce Clause was not designed to place interstate commerce in a privileged position.

ARGUMENT

Before turning to the legal arguments offered by petitioner, it is worth pausing to consider several elements of the North Carolina system of taxation that petitioner disregards. *First*, although petitioner treats the discriminatory nature of the taxable percentage deduction as self-evident (see Pet. Br. 15-16), North Carolina's tax regime actually differs in significant respects from those that have been held invalid under the Commerce Clause. The State does not distinguish between corporations or their products on the basis of domicile. Instead, the taxability of corporate shares is determined by the formula used to apportion corporate income, which in turn looks to the percentage of the corporation's payroll, property, and sales present in North Carolina (with the latter factor double-weighted). At least as to the sales factor, this approach is the *mirror-image* of a tariff, which is "the paradigmatic Commerce Clause violation" (*West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2217 (1994)): the tax scheme encourages out-of-state firms to sell their goods in North Carolina, in competition with firms domiciled in the State. That is hardly the "economic protectionism" at which the Clause is aimed. *Associated Industries of Missouri v. Lohman*, 114 S. Ct. 1815, 1820 (1994).

Second, as a practical matter it is doubtful that the taxable percentage deduction has any actual effect at all on interstate commerce. The "large national corporations" whose shares are 100% (or almost 100%) taxable by North Carolina (see Pet. Br. 5) plainly do not compete for capital with the "incorporated purely local businesses such as corner drugstores, professional associations and the like" (Pet. Br. 4), whose shares are exempt from taxation. Cf. *Alaska v. Arctic Maid*, 366 U.S. 199, 204 (1961) (looking to taxes imposed on competitors to gauge Commerce Clause violation). The intangibles tax, moreover, is imposed at the exceedingly low rate of 25 cents per \$100 of share value. It therefore is no surprise that interstate corporations *never* have expressed concern to the State about the effect of the taxable percentage deduction either on their operations or on their ability to attract capital. See J.A. 15-20.

Having said that, we nevertheless accept for purposes of the following argument that the taxable percentage deduction, viewed in isolation, does discriminate against interstate commerce. Even on that assumption, however, North Carolina's system of taxation plainly comports with the requirements of the Commerce Clause. Because corporate income and corporate shares reflect equivalent values, the taxable percentage deduction allows the State to avoid duplicative taxation of intrastate commerce. At the same time, taxation of shares issued by firms that are not subject to North Carolina's income tax — firms that fully avail themselves of the benefits of participation in the State's capital market — serves to ensure that interstate commerce "pay[s] its way." *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 114 S. Ct. 1345, 1351 (1994) (citation omitted). Invalidity of that system would work a significant and unwarranted interference with the States' "indispensable power of taxation." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

A. This Case Is Controlled By *Darnell v. Indiana*

At the outset, this case is quite plainly controlled by the Court's decision in *Darnell v. Indiana*, 226 U.S. 390 (1912). As petitioner describes it, *Darnell* involved an Indiana tax on "100% of all stock of [Indiana] residents," with allowance of "a credit or prepayment of taxes paid by a related party — the domestic corporation." Br. 21. But that is a mischaracterization of the case. In fact, *Darnell* involved a tax that was in all essential respects identical to North Carolina's tax on intangibles, and the Court in *Darnell* rejected Commerce Clause arguments indistinguishable from those advanced here by petitioner.

Like the North Carolina tax at issue in this case, the Indiana intangibles tax challenged in *Darnell* was levied on ownership of corporate shares. Indiana taxed all shares both of foreign corporations and of domestic corporations that conducted their business out-of-state; in contrast, the shares of domestic corporations that conducted their business in-state and themselves paid property tax to Indiana were exempt from the intangibles tax, just as the shares of corporations that pay North Carolina's income tax are exempt from that State's levy on intangibles. See *Darnell*, 226 U.S. at 397; *Indiana Dept. of State Revenue v. Felix*, 571 N.E.2d 287, 290 (Ind. 1991).⁴ The taxpayer in *Darnell* contested the tax

⁴ Petitioner describes (at Br. 19) the tax in *Darnell* as one "on stock value imposed on shareholders of domestic Indiana corporations, with a reduction in the tax base dollar-for-dollar as the domestic corporation's property tax base in the State increased. Shareholders of foreign corporations paid property tax on 100% of the value of their stock whether or not the corporation owned property in Indiana." But these were not quite the terms in which the State put the tax. Instead, the State taxed "all shares in foreign corporations * * *, and all shares in domestic corporations when the property of such corporations [was] not exempt or [was] not taxable to the corporation itself. If the value of the stock exceeds

on Commerce Clause grounds, claiming — like petitioner here — that the levy discriminated “in favor of domestic stocks as against shares in a foreign corporation, and that a resident owning stock in a domestic corporation escapes taxation thereon, while his next-door neighbor owning shares of stock in a foreign corporation is required to pay taxes on his holdings.” *Darnell v. State*, 90 N.E. 769, 773 (Ind. 1912).

The Indiana Supreme Court upheld the tax, using an analysis that closely mirrored that adopted by the court below in this case. The Indiana court explained:

Domestic corporations are taxed upon all their property. * * * The State, in its discretion, might tax the shares of stock in such corporation to the individual owners thereof residing in this State, but it would in a sense be double taxation, and it has not been the policy of this State to do so. Shares of stock in a foreign corporation doing business in another state, owned and held by a resident of this State, are taxed because they have not been and cannot be otherwise taxed by this State. * * * The man who resides in a state and enjoys the benefits of its schools, churches, society, highways and other public accommodations, as well as its governmental protection over his person and property, is in no position to

that of the tangible personal property this excess is also taxed.” *Darnell*, 226 U.S. at 397. The Court noted that this scheme arguably was problematic because it did “not make allowance if a foreign corporation ha[d] property taxed within the State,” but the Court did not address the constitutionality of that distinction because none of the corporations in which the taxpayer held shares was shown to have property in Indiana. *Id.* at 398. The North Carolina scheme does not have any such discriminatory feature; the State *does* make the taxable percentage deduction available to taxpayers who hold shares in foreign corporations that do business in North Carolina.

complain when required to contribute by taxation ratably upon his property for the maintenance of these institutions and the local government. It is clear to our minds that the tax law of Indiana is not open to the charge of discrimination against stock in foreign corporations, but imposes only just and equal burdens upon all corporate stocks, without regard to the place of incorporating or of conducting the corporate business, and does not violate either the third clause of section 8, art. 1, or the 14th amendment to the Constitution of the United States.

Darnell, 90 N.E. at 774.

The taxpayer repeated his argument before this Court, complaining that “[a]s the taxing statutes of Indiana as construed by her courts require all shares of stock in foreign corporations to be listed for taxation, while exempting from taxation, like shares of stock in domestic corporations, they violate the commerce clause of the Constitution.” *Darnell*, 226 U.S. at 392. But the Court disagreed, holding in a unanimous opinion by Justice Holmes that “[t]he only difference of treatment [between domestic and out-of-state corporations] * * * is that the State taxes the *property* of domestic corporations and the *stock* of foreign ones in similar cases. * * * [T]his is consistent with substantial equality notwithstanding the technical differences * * *.” *Id.* at 398 (emphasis added).

Petitioner’s single attempt to distinguish *Darnell* — its assertion that Indiana “simply used the corporate property tax as a prepayment of the shareholder’s property tax” (Br. 21) — is wrong both as a description of the levy and as an explanation of the Court’s holding. There was no suggestion in Indiana’s tax scheme that the payment of property tax by the domestic corporation was a “prepayment” of the shareholder’s obligation. See *Felix*, 571 N.E.2d at 290; *Darnell*, 90 N.E. at 773. Instead, the State sought to ensure

taxation of all values represented by corporate property that had some connection to Indiana; the property of domestic corporations was subject to a direct tax, while that of foreign corporations was reached through the medium of the intangibles tax on shares. This approach was upheld on the understanding that taxes on the *property* of domestic corporations on the one hand, and on the *stock* of foreign ones on the other, produced "substantial equality." *Darnell*, 226 U.S. at 398.

Petitioner also suggests (at Br. 20) that *Darnell*'s finding of "substantial equality" is inapposite here because both taxes in that case were levied on types of property (tangible property on the one hand and corporate shares on the other, see 226 U.S. at 397). But there is little doubt that the equivalence between the values reached by the income and shares taxes at issue in this case is considerably *stronger* than the relationship between the taxes challenged in *Darnell*. Shares of stock actually derive their value from corporate income, not from corporate property. It thus is uniformly recognized that corporate property is not a strong contributing factor to the value of the corporation's stock; the value of the company's tangible assets matters only when the company is liquidated or sold.

Instead, the market values corporate stock as the present value of the expected future cash flow from the stock, discounted to present value. Because dividends largely determine the stock's future cash flow, and because the corporation's income largely determines the amount of the dividends, the corporation's income provides the best single indicator of the value of its stock. See, e.g., J. Weston & E. Brigham, *Essentials of Managerial Finance* 254-257 (10th ed. 1993); T. Copeland, T. Koller & J. Murrin, *Valuation: Measuring and Managing the Value of Companies* 97 (1990). Accordingly, a tax on corporate income is a *better* proxy for one on corporate shares than is the tax on corporate property upheld in *Darnell* — and a State that wants to "tax only once

the value of stock" (Pet. Br. 20) may do so most effectively by making use of the North Carolina system. *Darnell* therefore dictates the outcome here.

B. North Carolina's Taxes On Intangible Property And Income Are Complementary

Perhaps recognizing that *Darnell* is not fairly distinguishable from this case, petitioner maintains (at Br. 21) that the decision nevertheless should be disregarded because the Court in *Darnell* assertedly did not apply what we now call the compensatory tax doctrine. In this contention, petitioner plainly is incorrect. The Court had recognized and applied the compensatory tax doctrine long before the decision in *Darnell*. See, e.g., *Hinson v. Lott*, 75 U.S. (8 Wall.) 148 (1869); *Oregon Waste Systems*, 114 S. Ct. at 1352 (discussing *Hinson*); Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405, 409-410 (1986). Moreover, the test actually applied in *Darnell* — that of "substantial equality" in the taxation of in-state and out-of-state interests — is identical to the one articulated by the Court in its modern compensatory tax decisions. See, e.g., *Boston Stock Exchange*, 429 U.S. at 332 (requirement of "substantially even-handed treatment"); *Oregon Waste Systems*, 114 S. Ct. at 1352 (taxes must be "rough equivalent[s]"). The two courts to have considered the question, the court below in this case and the Indiana Supreme Court in *Felix*, therefore both have concluded that *Darnell*'s "'substantially equivalent events' test is still used today to sustain taxes challenged under the commerce clause." *Felix*, 571 N.E.2d at 291. See Pet. App. 8a-16a. Indeed, this Court very recently cited *Darnell* as a part of its discussion of "paired (or 'compensating') tax schemes that have passed constitutional muster." *Oklahoma*

Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331, 1342 n.6.⁵

In any event, the North Carolina intangibles tax plainly does satisfy the requirements of the compensatory tax doctrine as they recently have been described by the Court. "Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause." *Oregon Waste Systems*, 114 S. Ct. at 1352. See *Associated Industries*, 114 S. Ct. at 1821. This principle rests on more than an esthetic concern with symmetry. Instead, its "most powerful justification * * * is constitutional necessity," for "[i]f the Constitution shields the protected interest from taxation under the state's general tax structure, but permits the state to achieve tax equality by other means, a scheme of complementary taxes is a defensible response." Hellerstein, *supra*, 39 Tax Law. at 452. The doctrine thus is "a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means" (*Oregon Waste Systems*, 114 S. Ct. at 1352): it ensures that in-state economic interests will not be disadvantaged by the State's inability to impose identical taxes on out-of-state competitors.

The inquiry whether a compensatory tax produces substantial equality involves a "practical conception" of

⁵ In citing *Darnell*, the Court "express[ed] no opinion on the need for equal treatment when a credit is allowed for payment of in- or out-of-state taxes by a third party." *Jefferson Lines*, 115 S. Ct. at 1342 n.6. This is a reference to the feature of the Indiana scheme under which shareholders in domestic — but not foreign — corporations were exempt from the intangibles tax insofar as the corporation paid property tax to Indiana. As we note above (at note 4, *supra*), the Court in *Darnell* also left open the constitutionality of that approach.

discrimination (*Associated Industries*, 114 S. Ct. at 1824, quoting *Gregg Dyeing Co. v. Query*, 286 U.S. 472, 481 (1932)), rather than a technical or formalistic one. "The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor precision of technical phrasing in their exercise of the most basic power of government, that of taxation." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). Instead, the Court's compensatory tax decisions have looked in a concrete sense to whether in- and out-of-state interests are asked to make equivalent contributions, and whether they do so in a manner that disadvantages interstate commerce.

In conducting this inquiry, the Court has been guided by three considerations. First, the State "must, as a threshold matter, 'identif[y] ... the [intrastate tax] burden for which the State is attempting to compensate.'" *Oregon Waste Systems*, 114 S. Ct. at 1352, quoting *Maryland v. Louisiana*, 451 U.S. 725, 758 (1981) (bracketed material added by the Court). Next, "the tax on interstate commerce must be shown roughly to approximate — but not exceed — the amount of the tax on intrastate commerce." *Ibid.* Finally, "the events on which the interstate and intrastate taxes are imposed must be 'substantially equivalent'; that is, they must be sufficiently similar in substance to serve as mutually exclusive 'proxies' for each other." *Ibid.*, quoting *Armco Inc. v. Hardesty*, 467 U.S. 638, 643 (1984).

Application of that test here reveals the North Carolina intangibles tax to be a compensatory levy that serves the wholly legitimate and salutary purpose of subjecting those engaged in interstate commerce to their "just share of state tax burden[s]." *Oregon Waste Systems*, 114 S. Ct. at 1351, quoting *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938). In-state firms that raise funds through North Carolina's capital markets pay for that privilege through the state income tax; out-of-state firms contribute on substantially equal terms to the maintenance of that market

through the medium of the intangibles tax. That tax thus rests squarely on "the settled principle that interstate commerce may be made to pay its way." *Oregon Waste Systems*, 114 S. Ct. at 1351 (citation and internal quotation marks omitted).

1. *The Intangibles Tax Compensates for the Income Tax.* a. In arguing that the intangibles tax does not validly complement the state income tax, petitioner's principal contention (at Br. 22-24) is that the State's system fails the first prong of the compensatory tax inquiry because there is no in-state burden for which the intangibles tax may properly compensate. This argument is premised on petitioner's assertion that the State is obligated to identify a "burden on intrastate commerce that is being *improperly* avoided by interstate commerce" (Br. 22 (emphasis in original)); because "North Carolina has no right to tax the corporate income earned out-of-state" (*ibid.*), petitioner continues, the State lacks the power to impose a tax that compensates for the one imposed on corporate income earned by in-state firms. See *id.* at 22-23.

This contention, however, reveals a fundamental misunderstanding of the compensatory tax doctrine. In fact, it is the very *point* of the doctrine to permit States to tax values indirectly that they lack the power to tax directly. In the first of this Court's compensatory tax cases, for example, Alabama was permitted to impose a tax on dealers who imported liquor from out-of-state to compensate for a tax imposed on in-state distillers; this approach was necessary precisely because Alabama lacked the power to lay a tax directly on distillers operating in other States. *Hinson*, 75 U.S. (8 Wall.) at 153. And the point is nicely illustrated by the example of compensating sales and use taxes, which petitioner itself recognizes (at Br. 23) as the paradigm of valid complementary taxes. A State that imposes a tax on in-state sales lacks the power to impose a similar levy on out-of-state sellers who make sales to in-state consumers (see, *e.g.*,

Quill Corp. v. North Dakota, 504 U.S. 298 (1992)) — in petitioner's terms, it "has no right to tax the [sales made] out-of-state" (Pet. Br. 22). But the State may compensate by taxing the purchaser's in-state *use* of property that was purchased out-of-state. See *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).

Thus, as a leading commentator has explained,

In the context of * * * the compensating use tax * * * the Supreme Court has recognized and approved the circuitous measures that the states have taken to achieve tax equality indirectly when the Constitution prohibits them from achieving it directly. In *Henneford v. Silas Mason Co.*, the Court was under no illusion that Washington's compensating use tax was anything other than a device to circumvent limitations that the commerce and due process clause[s] * * * imposed on the state's power to extend its sales tax to goods purchased out of state for local consumption. In describing the relationship of the use tax to the sales tax, the Court acknowledged that "the plan embodied in these provisions is neither hidden nor uncertain." Yet the Court resisted the conclusion that the tax was a "subterfuge" for a tax upon the out-of-state sale because "equality not preference [was] the end to be achieved."

Hellerstein, *supra*, 39 Tax Law. at 453, quoting *Silas Mason*, 300 U.S. at 581, 587, 586. "Hence if the states may not impose their general sales taxes upon out-of-state sales, but may achieve tax equality with regard to all goods purchased for in-state consumption, a compensating use tax on goods purchased out of state designed to produce such equality is a theoretically unobjectionable instrument of state tax policy." *Id.* at 452.⁶

⁶ As Professor Hellerstein has noted, "[t]o be sure, it is strange doctrine that unabashedly permits states to do indirectly what they

Here, of course, the state income tax (or at least that portion of the tax dedicated to maintaining conditions that facilitate the in-state sale of shares) is the “[intrastate tax] burden for which the State is attempting to compensate.” *Oregon Waste Systems*, 114 S. Ct. at 1352 (citation omitted). Corporations that do business in North Carolina — whether by owning property, employing a workforce, or generating sales — pay through the corporate income tax for that privilege, in the process supporting the functioning of North Carolina’s capital market. Absent the intangibles tax, however, companies whose only connection with North Carolina is the sale of shares to residents of the State would not bear any tax burden, even though those firms take full advantage of the State’s services in creating conditions conducive to the raising of capital. In petitioner’s case, for example, all but one of the companies in which it owns stock are immune from North Carolina’s direct taxing power. Were it not for the intangibles tax, the State would be wholly unable to assess against those companies their fair share of the costs of maintaining North Carolina’s capital market. The intangibles tax thus seeks to impose upon those companies, through their shareholders, a burden already borne by in-state firms.⁷

cannot do directly. * * * But such doctrine, while strange, is firmly embedded in constitutional law.” *Hellerstein*, *supra*, 39 Tax Law. at 453 n.453.

⁷ As we explain in more detail below (at 31-33), it does not matter for purposes of the compensatory tax doctrine that the income and intangibles taxes nominally fall on different categories of taxpayers. Indeed, the shares tax raises an issue under the Commerce Clause only to the extent that its effects are felt by the out-of-state issuers of shares, since “[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes.” *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989). Cf. *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205, 2216 (1994)

b. There is no reason to doubt that in appropriate circumstances a state income tax may serve as the intrastate tax burden for which a compensatory tax properly may be imposed. As a general matter, the Court has been prepared to assume that “various * * * means of general taxation, such as income taxes, could serve as an identifiable intrastate burden roughly equivalent to the out-of-state [tax].” *Oregon Waste Systems*, 114 S. Ct. at 1353. And in the particular circumstances of this case, where history makes plain that the income and intangibles taxes were *in fact* regarded as duplicative of one another, the income tax may validly be regarded as an identifiable levy for which the State may impose a compensatory burden on out-of-state entities.

In its initial form, North Carolina’s intangibles tax exempted all corporate shares, but was imposed on other intangibles at the same rate as the tax on real property (in 1928, nearly 3%). In that year, the State Tax Commission found that the high rate of the tax caused “many owners of intangibles [to] face virtual confiscation of their income,” while other property owners took advantage of the exemption for shares by investing “in stocks to the detriment of other [investments] such as bonds and mortgages.” 1928 Report of the State Tax Commission at 342-343, 346.

To address this problem, the State Tax Commission considered the possibility that all intangible property be exempted from tax, explaining that one

reason advanced for complete exemption is that intangibles are, for the most part, merely paper representatives of real property already taxed. To tax intangibles means, therefore, double taxation. Since double taxation of property is assumed to be undesirable,

(discriminatory tax formally imposed on in-state taxpayer unconstitutional because it “will result in a disadvantage to the out-of-state producer”).

the conclusion seems to follow that intangibles should be exempt.

1928 Report at 352.

Because total exemption of intangible property from tax would produce a substantial revenue loss, however, the Tax Commission considered at greater length the possibility of taxing intangibles at a low rate.⁸ With regard to corporate shares, the Tax Commission noted:

Shares of stock of domestic corporations are now exempt from taxation on the ground that the real and personal property of the corporation has paid its tax, presumably within the state, and that to tax the shares separately would be objectionable double taxation. Also on the ground that *in so far as the corporation has high earning power with little or no tangible property, we are reaching it through our corporate excess tax.*

Shares of foreign corporations, as already pointed out, are at present entirely exempt. If the corporation owns property in this state, it pays on its tangible property but nothing on its corporate excess. If it owns no property in the state, neither it nor the resident shareholder pays anything. It is not the exemption of foreign stock *per se* that is objectionable, but the discrimination involved in exempting stock and taxing bonds and other intangibles.

If shares of stock are made taxable, instead of exempting domestic and taxing foreign shares, a different distinction might well be made. All shares could be exempted to the extent that the property of the corporation is taxed within the state. Conversely all

⁸ This would require amending the state constitution, which mandated that intangible and real property be taxed at a uniform rate. N.C. Const. Art. VII, § 9, 1868.

shares owned by residents could be taxed to the extent that the corporation is not paying within the state on its property. This would mean that if a domestic corporation owned half of its property within the state and half outside, its shares owned by North Carolinians would be exempt only to 50 per cent of their value. If a foreign corporation had 25 per cent of its property in this state, 25 per cent of the value of its shares would be exempt on the part of the owner.

1928 Report at 356-357 (emphasis added).

The system recommended by the State Tax Commission was put in place in 1937, following the amendment of the North Carolina Constitution to permit differential tax treatment of different classes of property. Initially, all corporate shares were subject to tax, with an exemption for "stock in such corporations as pay a franchise and property tax in this State, and the tax upon the proportionate part of their income earned in this State." 1937 N.C. Sess. Laws c. 127 s. 706. The statute was put in something very like its present form two years later, in 1939, when the total exemption for stock issued by a corporation that paid any amount of property, franchise, or income tax was replaced by a proportionate exemption essentially identical to the current taxable percentage deduction. 1939 N.C. Sess. Laws c. 158 s. 705.⁹

⁹ The 1939 version of the statute provided:

[N]or shall the tax apply to shares of stock in corporations which pay to this State a franchise tax on their entire capital stocks, surplus and undivided profits or entire gross receipts * * * together with the tax upon all of the net income, if any, of such corporations. * * * With respect to corporations which pay to this State a franchise tax on part of their gross receipts * * * and a tax upon a part of the net income of such corporations * * * there shall be exempt so much of the fair

Several points come clear from this history. First, the State expressly understood the intangibles tax on shares to reach values that were interchangeable with the property and income taxes — meaning that the taxable percentage deduction was intended to prevent duplicative taxation of in-state values. Second, far from setting out to discriminate against out-of-state firms, North Carolina chose *not* to “exempt[] domestic and tax[] foreign shares,” instead exempting “[a]ll shares * * * to the extent” that corporate values already were taxed within the State. 1928 Report at 357.¹⁰ The necessary conclusion is that the income tax is a “specific charge on intrastate commerce” (*Oregon Waste Systems*, 114 S. Ct. at 1352) for which “the State is attempting to compensate.” *Ibid*.

2. *The Complementary Taxes are Substantially Equivalent.* a. As to the second prong of the compensatory tax test, it is evident that the amount of tax imposed by North Carolina on interstate and intrastate commerce is substantially similar. In arguing that this rough equivalence is not good enough, petitioner asserts principally (Br. 25-26) that the

market value of such shares of stock as is represented by the percentage of net income of which tax is paid to this State.

1939 N.C. Sess. Laws c. 158 s. 705. The reference to the franchise tax was deleted in 1955 (1955 N.C. Sess. Laws c. 1343 s. 2), but the tax on shares otherwise has in relevant part remained essentially unchanged.

¹⁰ The State Tax Commission was referring to the tax on corporate property, as well as to the one on income (or “corporate excess”), as the levy that corresponded to the tax on shares. But in-state property is now taken into account as an element of the income tax apportionment formula. In any event, as we explain above (at 14), a tax on corporate income is a better proxy for the value represented by corporate shares than is one on tangible property.

Court has recognized a “‘strict rule of equality’” requiring that the taxes on interstate and intrastate commerce be *identical* in every case. Br. 25, quoting *Associated Industries*, 114 S. Ct. at 1823. This contention, however, reads language from *Associated Industries* wildly out of context, in the process grossly distorting the meaning of that decision.

In referring to a “strict rule of equality,” the Court in *Associated Industries* found that routine discrimination against interstate commerce in one set of transactions cannot be supported by discrimination in favor of interstate commerce by *other* jurisdictions in *unrelated* transactions. The Court thus “rejected any theory that would require aggregating the burdens on commerce across an entire State to determine the constitutionality of a burden on interstate trade imposed by a particular political subdivision of the State.” 114 S. Ct. at 1822. The Court similarly was unpersuaded by the suggestion “that patent discrimination in part of the operation of a tax scheme, *not directly justified under any theory such as the compensatory tax doctrine*, can be rendered inconsequential for Commerce Clause purposes by advantages given to interstate commerce in other facets of a tax plan or other regions of a State.” *Ibid*. (emphasis added).

But the Court in *Associated Industries* plainly did not mean to hold that a compensatory tax scheme must be invalidated in its *entirety* whenever the State is unable to demonstrate a precise dollar-for-dollar equivalence in the burden imposed on in-state and out-of-state taxpayers in *every* case. As a general matter, the Court has characterized “[r]ough approximation rather than precision” as “the norm” in any tax system. *Illinois Cent. R.R. v. Minnesota*, 309 U.S. 157, 161 (1940). And just one month before the decision in *Associated Industries* was issued, the Court explained in *Oregon Waste Systems* that “the tax on interstate commerce must be shown *roughly to approximate* — but not exceed — the amount of the tax on intrastate commerce.”

114 S. Ct. at 1352 (emphasis added). See *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 77 (1963) (Brennan, J., concurring) ("the Constitution does not mandate absolute equality of treatment as between in-state and out-of-state sales").

That this has long been the Court's approach is demonstrated by *Alaska v. Arctic Maid*, 366 U.S. 199 (1961), a decision cited as illustrative of the applicable test in *Oregon Waste Systems*. See 114 S. Ct. at 1352. In *Arctic Maid*, Alaska imposed a 4% tax on the value of fish frozen by Washington-based freezer ships; in practice the frozen fish invariably were transported to Washington for canning. Alaska imposed a distinct tax of 6% on Alaskan canneries, which was measured by the value of fish obtained for canning in Alaska. See 366 U.S. at 200-201, 204. The Court upheld the tax on freezer ships against a Commerce Clause challenge, explaining that

[w]hen we look at the tax laid on local canners and those laid on "freezer ships," there is no discrimination in favor of the former and against the latter. For no matter how the tax on "freezer ships" is computed, it did not exceed the six-percent tax on the local canners. * * * If there is a difference between the taxes imposed on these freezer ships and the taxes imposed on their competitors, they are not so "palpably disproportionate" * * * as to run afoul of the Commerce Clause.

Id. at 204-205 (citations omitted).¹¹ See also, *e.g.*, *Dunbar-*

¹¹ There is a suggestion in *Armco* that *Arctic Maid* involved a statute that "merely laid a nondiscriminatory tax on a particular kind of business, operating freezer ships in Alaska," which "was deemed a different kind of business from operating a cannery in Alaska." 467 U.S. at 643 n.7. But it is apparent from the opinion that "the Court in *Arctic Maid* did not view the business as being different, or at least did not view that as a critical factor."

Stanley Studios, Inc. v. Alabama, 393 U.S. 537, 542 (1969).

Indeed, the same principle comes clear from *Associated Industries* itself, where the Court held that States may impose taxes on interstate and intrastate commerce that are not identical, so long as the greater burden is borne by intrastate businesses. See 114 S. Ct. at 1824. As the Court put it, "in focusing on equality, our cases have addressed the *limit* of permissible state regulation of interstate commerce. In setting the limit at equality, we have not suggested that lesser burdens on interstate trade are impermissible; that is, we have not demanded equality *and nothing but equality* in compensatory tax cases." *Id.* at 1823 n.4 (emphasis in original).

b. That conclusion is dispositive here, for it is undeniable that the burden imposed by North Carolina on interstate businesses will be considerably *lower*, in the vast run of cases, than that imposed on intrastate firms. This point was demonstrated by the court below, which observed that

corporate income, and income tax paid, are strongly related to the value of the corporation's stock. The strength of this relationship is aptly demonstrated by the fact that economists and investors frequently make use of the "price-earnings ratio," or P/E ratio, which essentially represents the relationship of the value of a corporation's stock to its earnings. See, *e.g.*, 3 *The New Palgrave Dictionary of Money & Finance* 176 (1992).

Lathrop, *Armco — A Narrow and Puzzling Test for Discriminatory State Taxes Under the Commerce Clause*, 63 *Taxes* 551, 559 (1985). Instead, the Court discussed the taxes as being compensatory. The Court accordingly has cited *Arctic Maid*, both before and after the decision in *Armco*, as an application of the compensatory tax doctrine. See *Oregon Waste Systems*, 114 S. Ct. at 1352; *Boston Stock Exchange*, 429 U.S. at 332.

Pet. App. 12a.

The court went on to explain:

North Carolina taxes corporate income at 7.75 percent and taxes ownership of stock at .25 percent of the taxable value of the stock. Given these tax rates, a North Carolina corporation need only have a P/E ratio less than 31 (7.75/.25) in order to have the tax against its income exceed the intangibles tax against the stockholders of a comparable corporation doing business only in [other States] and having all of its shareholders in North Carolina. Since P/E ratios are only rarely greater than 31, most out-of-state corporations will in fact be paying less taxes to North Carolina, directly in the form of an income tax and indirectly in the form of an intangibles tax against shares, than a similar North Carolina corporation.

Pet. App. 13a-14a (footnotes omitted).¹²

Petitioner pointedly does not challenge the validity of the empirical analysis used below (see Br. 25-26), and accordingly does not deny that the tax burden imposed by North Carolina upon out-of-state firms is *in fact* considerably lower (at least as a general matter) than that imposed upon in-state firms. Indeed, because the number of shares issued by an out-of-state firm that are owned by North Carolina residents will be relatively small (certainly far fewer than 100% of the outstanding shares), the actual dollar amounts paid by the out-of-state firm's shareholders will in almost every case be vastly lower than the amount paid in income tax by a comparable firm whose business is confined to North Carolina. Petitioner therefore contends (at Br. 26) only that

¹² As the court noted (Pet. App. 14a n.8), the Standard & Poors composite index for P/E ratio during the period 1926-1991 generally was between 10 and 20, and never exceeded 25.

firms doing business across state lines run the risk of being subjected to multiple tax burdens that are not imposed on firms that conduct a wholly intrastate business. That argument, which raises issues under the internal consistency test, is addressed below (at 36-45). But petitioner's contention is simply beside the point for present purposes, for the burdens imposed upon interstate and intrastate commerce by *North Carolina* are equivalent, confirming that the intangibles tax does compensate for the levy on income.

Of course, if a particular taxpayer could demonstrate that the intangibles tax effected a higher levy than the income tax imposed on an equivalent firm whose business is confined to North Carolina, we might agree that the taxpayer would be entitled to relief. But petitioner has not even attempted to make any such showing here. And the possibility — or even, as *Associated Industries* shows, the demonstrated fact — that one set of interstate transactions will be subjected to a discriminatory tax does not invalidate the tax scheme as a whole. The Court has “never deemed a hypothetical possibility of favoritism to constitute discrimination that transgresses constitutional commands. On the contrary, [the Court] repeatedly ha[s] focused [its] Commerce Clause analysis on whether a challenged scheme is discriminatory in ‘effect.’” *Associated Industries*, 114 S. Ct. at 1824, quoting *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984). There is no such impermissible effect here.

It may be added that the claim of equivalency is not affected by the State's failure to precisely quantify the portion of the corporate income tax dedicated to paying for the privilege of participating in North Carolina's capital markets. Although North Carolina has chosen to assess taxes upon out-of-state corporations using the State's capital markets at a much lower rate than that imposed upon corporations engaging in more widespread activities in the State, it is not constitutionally required to do so. As the Court explained in *Cotton Petroleum Corp. v. New Mexico*, “there is no

constitutional requirement that the benefits received from a taxing authority by an ordinary commercial taxpayer — or by those living in the community where the taxpayer is located — must equal the amount of its tax obligations.” 490 U.S. 163, 190 (1989). “Interstate commerce may thus be made to pay its fair share of state expenses and contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct benefit.” *Jefferson Lines*, 115 S. Ct. at 1346 (emphasis in original; citations and internal quotation marks omitted). See also *Carmichael v. Southern Coal & Coke Co.*, 301 U.S. 495, 522 (1937) (“A tax is not an assessment of benefits. It is, as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes.”); *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989) (no discrimination where tax was not apportioned because it was impossible “to measure the activities within the State” subject to tax).

3. *The Interstate and Intrastate Taxes Fall on Substantially Equivalent Events.* a. The remaining element of the compensatory tax inquiry looks to whether the interstate and intrastate taxes fall on substantially equivalent events. In arguing that the intangibles and income taxes do not satisfy this requirement, petitioner returns to its initial argument with the assertion “that the compensating tax must compensate for the inability to tax an event the state *has the power to tax*,” adding that “[t]he intangibles tax is not paid by the same class of taxpayer as the tax purportedly being compensated for and would not be paid upon the same amount or at the same rate.” Br. 27 (emphasis in original). We have already addressed the first of these points (see 18-19, *supra*); we add only that, if the State “has the power to tax” a particular event, it is not apparent what would prevent

the State from doing so directly — and what purpose would be served by the compensatory tax doctrine if that were the limits of the principle.

The second portion of petitioner’s argument — its contention that a compensating tax must fall upon activities and a class of taxpayers that are identical to those upon which the intrastate levy is imposed — rests on a similarly fundamental misunderstanding of the compensatory tax doctrine. The Court has stated repeatedly that States need not impose the compensatory tax either on the same taxable event or on the same category of taxpayers as the tax for which it compensates: “The end result under the theory of the compensatory tax is that, ‘when the account is made up, the stranger from afar is subject to no greater burdens ... than the dweller within the gates. *The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.*’” *Associated Industries*, 114 S. Ct. at 1821, quoting *Silas Mason*, 300 U.S. at 584 (1937) (emphasis added). Indeed, this concept is almost a truism, because if the State could reach the very activity in interstate commerce that is subject to the intrastate tax, there would be no reason to have a separate, compensatory tax in the first place. Thus, the Court has observed that “it is often no mean feat to determine whether a challenged tax is a compensatory tax,” indicating that taxes may compensate for one another even when the equivalence between them is not obvious, so long as they are “similar in substance.” *Oregon Waste Systems*, 114 S. Ct. at 1352.

In fact,

[b]y hypothesis, it would seem, the formal equivalence of one tax to another cannot be a criterion of complementarity. The very problem of the complementary tax arises precisely because the levies at issue are not formally equivalent — *i.e.*, they are classified differently or they have distinct legal

incidences. The essential question is whether, despite differences in form, they are equivalent in substance. The Court's precedents finding excise taxes that complement property taxes, use taxes that complement sales taxes, and manufacturing taxes that complement importation taxes stand squarely for the proposition that taxes need not be formally equivalent to one another to be complementary.

Hellerstein, *supra*, 39 Tax. Law. at 431 (footnotes omitted).

The use tax — the paradigm of the valid compensatory tax — again illustrates this point. The Court long has considered use and sales taxes sufficiently equivalent to sustain a compensatory tax defense. The plain fact, however, is that a tax on the sale of goods is different in significant respects from one on the use of goods: they fall upon different events (a sale in the one case and the use of merchandise in the other) that take place in different States and (in petitioner's words) may not be "paid by the same class of taxpayer" (sellers may pay on the one hand and ultimate consumers will pay on the other). Nevertheless, because the taxes fall upon activities generating *values* that are equivalent, the Court has held them to be complementary, ensuring that an out-of-state taxpayer does not use the Commerce Clause as a shield to avoid "pay[ing] its way." *Maryland v. Louisiana*, 451 U.S. at 754.

Moreover, as Professor Hellerstein has explained,

It is the rare tax that is the precise functional equivalent of another tax with a different name. Sales and compensating use taxes ordinarily fit this description. * * * None of the other taxes that the Court has considered as complementary, however, can be thought of as functional equivalents in the sense that they were identical except for the label attached to them. In each case there were differences in the substantive nature of the activities or transactions subject to the taxes, in the

measure of the taxes, or in other aspects of the transactions that would render their characterization as "functional equivalents" inaccurate.

Hellerstein, *supra*, 39 Tax. Law. at 432-433 (footnotes omitted).

b. Here, for reasons we already have explained (at 14, 21-24), the intangibles and income taxes are "substantially equivalent" in the sense of the term used by the Court. As a matter of economic reality, there is a close and manifest relationship between the value of corporate shares and the amount of corporate income, which serve as the respective tax bases. This case therefore stands on a decisively different footing from *Oregon Waste Systems*, where the State unsuccessfully asserted that "earning income and disposing of waste at Oregon landfills" — two wholly unrelated activities — were equivalent events. 114 S. Ct. at 1353. In this case, in contrast, the values reached by the shares tax are necessarily and directly dependent upon the values subject to the income tax. The Court, of course, already has reached just that conclusion in *Darnell*.¹³

In fact, *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984), the very decision relied upon by petitioner (at Br. 27-28), demonstrates that the taxes here do fall upon substantially equivalent events. There, West Virginia imposed a wholesaling tax on goods sold in-state by out-of-state manufacturers, while imposing a separate manufacturing tax on goods manufactured in-state. The Court rejected the contention that the wholesaling and manufacturing taxes were complementary, explaining (in the very language cited by petitioner at Br. 28) that "[t]he fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State * * * makes clear that the manufacturing

¹³ Indeed, as we have explained (at 14), this case is a stronger one than *Darnell* for a finding of equivalence.

tax is just that, and not in part a proxy for the gross receipts tax imposed on [the taxpayer] and other sellers from other States." *Id.* at 643 (emphasis added). Similarly, in *Oregon Waste Systems* the Court turned aside the contention that Oregon's discriminatory tax on the disposal of out-of-state waste compensated for the State's income tax, reasoning that "the very fact that in-state shippers of out-of-state waste * * * are charged the out-of-state surcharge even though they pay Oregon income taxes refutes [the State's] argument that the respective taxable events are substantially equivalent." 114 S. Ct. at 1353 (emphasis added). See also *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 243 (1987) ("The local sales of out-of-state manufacturers are also subject to Washington's wholesale tax, but the multiple activities exemption does not extend its ostensible compensatory benefit to those manufacturers").

Here, in contrast, firms that pay the state income tax do *not* pay the levy on intangibles, and firms whose shares are subject to the intangibles tax do *not* pay state income tax; the taxes are imposed in precise, inverse proportion to one another. Thus, to invert the analysis of *Oregon Waste Systems*, the fact that in-state firms are *not* liable for the intangibles tax when they *do* pay North Carolina income tax validates the State's argument that the respective taxable events are substantially equivalent. And the history of the levies demonstrates that the taxable percentage deduction was intended to ensure that the State would not impose duplicative taxation on what was understood to be a single corporate value. The taxes thus were expressly intended to, and in fact do, "serve as mutually exclusive 'prox[ies]' for each other." *Oregon Waste Systems*, 114 S. Ct. at 1352. They accordingly are complementary in the truest sense.

As a consequence, the Court's concern in *Oregon Waste Systems* that it might be plunged "into the morass of weighing comparative tax burdens" by comparing taxes on dissimilar events" simply is not present here. 114 S. Ct. at

1353, quoting *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 289 (1987). We do not contend, as the State did in *Oregon Waste Systems*, that the state income tax may serve as an all-purpose compensatory justification for discriminatory taxes imposed on interstate commerce. Nor does our argument suggest that a State may tax out-of-state businesses more heavily whenever "the entities involved in interstate commerce happened to use facilities supported by general state tax funds." *Oregon Waste Systems*, 114 S. Ct. at 1353 n.8 (citation omitted). Instead, the income and shares taxes here are directly linked in the text of the tax statutes, fall upon demonstrably related values, and are applied as substitutes for one another. That is the paradigm of a system of compensating taxes.

That the values reached by the taxes are substantially equivalent is confirmed by their similar practical effects. Needless to say, the income tax depresses real corporate income, thus driving down the value of the corporation's stock (which is substantially dependent upon income) and discouraging the purchase corporate shares — precisely the (theoretical) effect of the intangibles tax. The income tax thus depresses the flow of capital to North Carolina businesses in much the same way that the intangibles tax impedes the purchase of shares issued by out-of-state firms. That the one tax formally falls upon the corporation and the other upon the shareholder does not detract from this conclusion. After all, the Court has "emphasized that 'equality for the purposes of ... the flow of commerce is measured in dollars and cents, not legal abstractions.'" *Associated Industries*, 114 S. Ct. at 1824 (citation omitted). And "economic equivalence" plainly may exist in such circumstances: "For example, a tax imposed upon and borne by a lessee may be economically equivalent to a tax imposed upon a lessor, if the lessor is able to pass the burden of the tax on to the lessee in the form of increased rent." Hellerstein, *supra*, 39 Tax Law. at 434. Cf. *United States v.*

County of Fresno, 429 U.S. 452, 455 (1977). As we have explained (at note 7, *supra*), that is the case here.

C. The "Internal Consistency Test" Does Not Require Invalidation Of The Taxable Percentage Deduction

As an alternative argument, petitioner asserts that the intangibles tax — even if it satisfies the requirements of the compensatory tax doctrine — must be struck down because it fails the test of "internal consistency" that the Court has used to guide Commerce Clause analysis. But the Court never has applied the internal consistency test to invalidate a state tax in the circumstances of this case, where the challenged levy is a valid compensatory tax that is applied to intangible (and therefore unapportionable) property, and that is designed to reach values that are legitimately subject to tax but otherwise would escape taxation. Applying the test in the manner contended for by plaintiff would require a novel extension of the internal consistency doctrine that would work a substantial and wholly inappropriate interference with state taxing authority.

1. The internal consistency test has been used by the Court to assess "threat[s] of malapportionment." *Jefferson Lines*, 115 S. Ct. at 1338. The test "looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction * * *." *Ibid.* The test is not "a new doctrine that would 'revolutionize the law of state taxation.'" 1 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 4.08[1][a], at 4-43 (2d ed. 1993). Instead, it is a helpful tool for use in rooting out subtly malapportioned or discriminatory taxes. That has been the value of the test in each of the three cases in which the Court has applied it to

invalidate a state tax. See *Scheiner*, 483 U.S. at 285-286 (flat highway tax fails internal consistency test because it effectively imposes per mile cost on interstate truckers that is five times that imposed on intrastate truckers); *Tyler Pipe*, 483 U.S. at 243-244 (tax held not compensatory and therefore discriminatory); *Armco*, 467 U.S. at 642-643 (same). See generally Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 138 (1988).

But the internal consistency test has not been applied in a case like this one where, far from "tak[ing] more than its fair share of taxes from the interstate transaction," the challenged levy is intended to make interstate commerce shoulder its appropriate share of the state tax burden. In making this point, it is important to note at the outset that the out-of-state firms that market their shares to North Carolina residents plainly are benefited by the "laws and amenities" (*Jefferson Lines*, 115 S. Ct. at 1339) of North Carolina in a most concrete way. The State "supplies a number of * * * civic services" that make possible development of the pools of affluent consumers who purchase shares (*D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 32 (1988)), and offers the "other advantages of civilized society" (*Goldberg*, 488 U.S. at 267) that are essential for the operation of functioning markets. It thus is evident that the burden indirectly imposed upon out-of-state firms through the medium of the intangibles tax is "tied to the earnings which the State * * * has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 446 (1940). See *Jefferson Lines*, 115 S. Ct. at 1346 (noting "the usual and usually forgotten advantages conferred by the State's maintenance of a civilized society").

There is, moreover, no requirement that the State demonstrate a dollar-for-dollar correspondence between the benefits that it provides to, and the tax that it imposes on, an

out-of-state commercial enterprise. In fact, determining that value in a case such as this one would be quite impossible. Thus, "[t]he tax which may be imposed on a particular interstate transaction need not be limited to the cost of the services incurred by the State on account of that particular activity." *Goldberg*, 488 U.S. at 267, quoting *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 627 n.16 (1981). Yet absent the intangibles tax, out-of-state issuers of shares — who cannot be reached by the state income tax — could not be required to contribute even indirectly to state coffers.

The Court never has struck down such a tax for failure to comport with the internal consistency test. To the contrary, in *Tyler Pipe*, one of the cases on which petitioner principally relies (see Br. 29-30), the Court expressly distinguished this very situation. There, Washington imposed a wholesaling tax on goods sold in the State and a manufacturing tax on products manufactured in the State; local manufacturers were exempted from the manufacturing tax on the portion of their output that was subject to the wholesaling tax (the so-called "multiple activities" exemption), but were not given an exemption for products sold (and potentially taxed) out-of-state. See 483 U.S. at 236-237. While the Court struck down the multiple activities exemption as discriminatory (see *id.* at 244-248), it also explicitly concluded that imposition of the manufacturing tax on goods sold out-of-state could not "be justified as an attempt to compensate the State for its inability to impose a similar burden on out-of-state manufacturers whose goods are sold in Washington, for Washington subjects those sales to wholesale tax." *Id.* at 244-245 n.12 (emphasis added). Similarly, in *Scheiner* and *Armco*, the other cases in which the Court has applied the internal consistency test to invalidate state taxation, the out-of-state taxpayer unquestionably was subject to direct taxation and therefore bore its fair share of state tax. See also *Container Corp. of*

America v. Franchise Tax Board, 463 U.S. 159 (1983). Here, in contrast, North Carolina is unable to impose a fair burden on out-of-state issuers of shares except through the medium of the intangibles tax.

Indeed, the Court never has applied the internal consistency test to invalidate an otherwise valid compensatory tax. In both *Armco* and *Tyler Pipe*, the Court went to considerable lengths to demonstrate that the state taxes at issue were *not* truly complementary — analyses that would have been wholly unnecessary had compensatory taxes been invalid under the internal consistency principle. See *Armco*, 467 U.S. at 642-643; *Tyler Pipe*, 483 U.S. at 242-244. See also *id.* at 253 (O'Connor, J., concurring); *Scheiner*, 483 U.S. at 302-303 (O'Connor, J., dissenting). And in *Scheiner*, the Court specifically noted that the flat tax at issue was *not* defended as "a compensatory tax that equalizes previously unequal tax burdens by offsetting 'a specific tax imposed only on intrastate commerce for a substantially equivalent event.'" 483 U.S. at 287 (citation omitted).

Ruling for petitioner accordingly would require the Court to make considerable new law. In fact, petitioner itself acknowledges (at Br. 33-34) that it can prevail only if the Court overrules *Darnell*. Petitioner's theory also would require the Court to overrule *Hinson v. Lott*, the venerable decision that the Court recently cited with approval as the fountainhead of the compensatory tax doctrine. *Oregon Waste Systems*, 114 S. Ct. at 1352. See Hellerstein, *supra*, 87 Mich. L. Rev. at 152-153 (discussing *Hinson*). Petitioner has not offered the Court any reason to take such a substantial step. By definition, after all, the combination of North Carolina taxes, because compensatory, does not work an impermissible discrimination against interstate commerce. And the tax cannot be considered malapportioned where the out-of-state corporation pays (in part indirectly through the shares tax) for the distinct benefits provided by the several States that facilitate its business.

2. Even if the internal consistency test would invalidate other sorts of complementary taxes, it should not be applied to strike down a tax on intangible property. Because intangible property has no identifiable location and may draw benefits from many jurisdictions, the Court has long held that taxes on such property need not be apportioned even though this may result in what appears to be duplicative taxation. Thus, a State may tax the full value of intangible property that has a situs in that State, even though the State of the taxpayer's domicile also may impose an identical tax on the same property. See *Curry v. McCanless*, 307 U.S. 357 (1939); *State Tax Comm'n v. Aldrich*, 316 U.S. 174 (1942).¹⁴ In such a situation, where no single State has exclusive control over the value subject to tax, where more than one State provides benefits and protections to the taxpayer, and where apportionment of the value taxed cannot meaningfully be achieved, unapportioned taxation is consistent with the Constitution.¹⁵

¹⁴ Similarly, the Court has held that a State may tax the entire income of its residents even though it also taxes an apportioned share of income earned in-state by nonresidents — a regime that would lead to multiple taxation if duplicated by other States. See *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937); *Lawrence v. State Tax Comm'n*, 286 U.S. 276 (1932); *Shaffer v. Carter*, 252 U.S. 37 (1920).

¹⁵ As Justice Stone wrote for the Court in *Curry*, 307 U.S. at 367-368 (footnote omitted):

[W]hen the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and laws of another state [in addition to his State of domicile], in such a way as to bring his person or property within reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax.

While the decisions cited above in text involved the apportionment requirement of the Due Process Clause, there is no reason to doubt that they also state principles controlling under the Commerce Clause. Cf. *Shaffer*, 252 U.S. at 56-57 (rejecting Commerce Clause challenge to statute that raised possibility of multiple taxation of income of domiciliaries); *Commercial Credit Consumer Services, Inc. v. Norberg*, 518 A.2d 1336 (R.I. 1986) (State permitted to tax entire net income of domestic corporation).¹⁶ In this connection, we note that in *Ford Motor Credit Co. v. Department of Revenue*, 500 U.S. 172 (1991), an equally divided Court affirmed a decision of the Florida Court of Appeal upholding

* * * [I]t is undeniable that the state of domicile is not deprived, by the taxpayer's activities elsewhere, of its constitutional jurisdiction to tax, and consequently that there are many circumstances in which more than one state may have jurisdiction to impose a tax and measure it by some or all of the taxpayer's intangibles. Shares of corporate stock may be taxed at the domicile of the shareholder and also at that of the corporation which the taxing state has created and controls; and income may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit, and power over the subject matter are not confined to either state.

Cf. *Allied-Signal, Inc. v. Director*, 112 S. Ct. 2251, 2262 (1992) (non-business corporate income from intangibles is, as a matter of practice, allocated by statute to the corporation's state of domicile).

¹⁶ The apportionment analysis under the Due Process and Commerce Clauses is identical. See, e.g., *Container Corp.*, 463 U.S. at 169; *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 227-228 (1980). And because any discrimination against interstate commerce in this case is overcome by the compensatory tax doctrine, the combination of North Carolina's income and intangibles taxes may be vulnerable, if at all, only to a claim of malapportionment.

Florida's property tax on intangibles, which permitted unapportioned taxation both by the owner's State of domicile and by the State where the intangibles had their business situs. Rejecting a Commerce Clause challenge, the court of appeal reasoned that "since [the taxpayer] has extended its activities regarding its intangibles to Florida and has availed itself of the benefits of the laws of several states with regard to this property, those several states, including Florida, may each impose a tax upon such intangible property." *Ford Motor Credit Co. v. Department of Revenue*, 537 So.2d 1011, 1012 (Fla. Ct. App. 1988). The court of appeal added that the internal consistency test would not invalidate such a property tax. See *id.* at 1013.

Petitioner's approach cannot survive application of this principle. Petitioner complains (at Br. 31) that North Carolina's tax regime, if adopted by every State, could lead to increased or duplicative burdens on firms that sell their shares across state lines.¹⁷ But that is the nature of intangible property, and of corporate shares in particular; because such property may be provided distinct benefits by more than one State, it long has been subject to unapportioned taxation by more than one State. Firms that sell their shares across state lines therefore subject those

¹⁷ We note that petitioner's argument (at Br. 31) that the intangibles tax is invalid because it might impose increased burdens on North Carolina firms that engage in interstate commerce cannot be reconciled with the Court's holding in *Goldberg* that "[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes." 488 U.S. at 266. See *id.* at 268 (Stevens, J., concurring in part and concurring in the judgment) (noting Court's holding that a State "may discriminate among its own residents by placing a heavier tax on those who engage in interstate commerce than on those who merely engage in local commerce"); *id.* at 270 (O'Connor, J., concurring in part and concurring in the judgment) (same).

shares to additional taxation. This may be explicable as a function of the practical impossibility of apportionment: unlike a multistate corporation's income, which has distinct and identifiable sources (and hence is apportionable), the values represented by intangibles may be thought to exist in (and receive equivalent protections from) two States. And where apportionment is not practical, the internal consistency test will not be used to invalidate a tax. See *Scheiner*, 483 U.S. at 297 (flat tax permissible where "administrative difficulties make collection of more finely calibrated user charges impracticable"); *Goldberg*, 488 U.S. at 266 (discrimination claim rejected where it was not "possible to measure the activities within the State").

3. Petitioner's answer to this problem is to insist (at Br. 32) that the State either forgo any tax on intangibles or impose the intangibles tax on precisely equivalent terms to the shares of both in-state and out-of-state corporations. But this approach places the State on the horns of a dilemma. Elimination of the tax would force the State to abandon any effort to get out-of-state firms to make their fair contribution to the maintenance of the North Carolina capital market in which they participate. And offering the shareholders of such corporations a credit against their intangibles tax for income taxes paid by the issuing corporation to *other* States (which would parallel the taxable percentage deduction offered to the owners of shares issued by corporations doing business only in North Carolina) would not be a workable approach. Again, that would mean that corporations that conduct all of their business outside of North Carolina but sell shares within the State — including five of the six firms in which petitioner holds shares — would entirely escape any obligation to shoulder their fair share of the state tax burden.¹⁸

¹⁸ That is not true of conventional sales/use tax regimes. It is true that States imposing use taxes almost universally provide a credit for sales taxes previously paid either in- or out-of-state. See

On the other hand, requiring the State to impose the intangibles tax on the shares of both intrastate and interstate firms without the taxable percentage deduction would subject intrastate commerce to duplicative taxation. Petitioner forgets that we are here proceeding on the hypothesis that the income and intangibles taxes satisfy the requirements of the compensatory tax doctrine. As a consequence, for present purposes it must be deemed established that the two taxes are imposed on equivalent values — and that the taxable percentage deduction furthers a legitimate local purpose (that of avoiding duplicative taxation on in-state firms) that cannot be achieved by nondiscriminatory means. See pages 16-17, *supra*. Requiring the State to disregard that purpose by subjecting intrastate commerce to duplicative taxation would contravene the fundamental principle that the Commerce Clause was not designed to “place such [interstate] commerce in a privileged position.” *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623 (1981).

In this situation, the Court should apply “the understanding that the Commerce Clause does not forbid the actual assessment of a succession of taxes by different States on distinct events.” *Jefferson Lines*, 115 S. Ct. at 1339-1340. To be sure, the Court in *Jefferson Lines* was discussing a succession of internally consistent taxes that formally fall on discrete activities. But that principle also should be applicable in the unusual circumstances of this case, where the State in which the interstate firm produces income and the State in which the firm’s shareholders reside each

Jefferson Lines, 115 S. Ct. at 1343; *Tyler Pipe*, 483 U.S. at 245 n.13. But because it generally has been thought that States may not impose sales taxes on the sale of products shipped out-of-state (see, e.g., *Evco v. Jones*, 409 U.S. 91, 93 (1972)), businesses (such as mail order firms) that ship products to other States are not subject to a sales tax, and therefore have nothing to credit against use taxes imposed by the State of purchase.

provides benefits that facilitate the interstate firm’s business. Cf. *id.* at 1339. Because the value represented by intangible property is not practically apportionable, because each of the taxing States “would presumably have * * * an equal claim on the taxpayer’s purse” (*id.* at 1343), and because North Carolina has a compelling interest in avoiding duplicative taxation of intrastate commerce, the taxable percentage deduction should not be held invalid under the internal consistency test.

D. If The Taxable Percentage Deduction Is Held Unconstitutional, The Case Should Be Remanded For Determination Of A Remedy

Finally, if the Court does hold the taxable percentage deduction unconstitutional, it should remand the case to the state courts so that they may determine the appropriate remedy. Petitioner also evidently recognizes (at Br. 9) that it is for the state courts to decide any remedial issues in the first instance. It is settled that a finding of unconstitutionality “does not in itself dictate the relief that the State must provide.” *Associated Industries*, 114 S. Ct. at 1825. Even assuming that the decision invalidating the tax is given retroactive effect, “the Due Process Clause would demand only that, ‘to cure the illegality of the tax as originally imposed, the State must ultimately collect a tax for the contested period that in no respect impermissibly discriminates against interstate commerce.’” *Ibid.*, quoting *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 44 n.27 (1990).

A State in such a situation may remedy unconstitutionality by retroactively raising taxes on the favored class, by offering refunds or credits to the disfavored class, or by some combination of the two. See *Associated Industries*, 114 S. Ct. at 1825; *McKesson*, 496 U.S. at 40 & n.23. But so long as the State’s choice comports with the U.S. Constitution, the question of remedy is one of state law

that should be settled by the state courts. See generally *Hooper v. Bernalillo County Assessor*, 472 U.S. 612, 624 (1985); *Zobel v. Williams*, 457 U.S. 55, 64-65 (1982). "The methods best adapted to achieving equal treatment in this case, whether partial or complete refunds or other measures, are similarly matters left for determination on remand." *Associated Industries*, 114 S. Ct. at 1825.

CONCLUSION

The judgment of the North Carolina Supreme Court should be affirmed.

Respectfully submitted.

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